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No. 74-1508

In the Supreme Court of the United States

OCTOBER TERM, 1975

ELOT H. RAFFETY FARMS, INC., PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

ROBERT H. BORK,
Solicitor General,
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Washington, D.C. 20530.

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Petitioner seeks review of the decision in this income tax case that a Mexican limited responsibility company to which it made capital contributions was an association taxable as a corporation so that petitioner could only deduct its unrecovered advances as capital losses.

The pertinent facts are as follows: In 1965, petitioner orally agreed with L.D. Joslyn and the Rolwing-Moxley Company to conduct cotton farming operations in Mexico. Under the arrangement, petitioner was to own a one-half interest in the enterprise, and Joslyn and Rolwing-Moxley were each to own a one-quarter interest. After discovering that Mexican law imposed limitations upon the conduct of farming operations by foreigners, the parties retained Mexican counsel to advise them how to conduct their farming operations. The Mexican counsel advised the formation of a Mexican limited responsibility company.

As a result, the parties organized a company known as El Sombrero Sociedad de Responsibilidad Limitada ("El Sombrero") to conduct the farming business. Under its charter, El Sombrero was authorized to lease land, process cotton and in general do all lawful acts related to an agricultural business; had an authorized capital structure of 3,000,000 pesos, to be provided by three Mexican organizers; had an authorized membership which was restricted to 25 members; and was required to conduct its business through an administrator. El Sombrero never issued any stock and petitioner never received any conveyance or assignment of any interest in it. The three Mexican organizers whose names appeared in El Sombrero's articles of organization did not contribute any capital to the business or perform any service for which they were paid (Pet. App. B A3-A5; Pet. App. C A12-A14).

During 1966 and 1967, the taxable years in issue, petitioner respectively advanced $200,000 and $22,000 to El Sombrero, and Joslyn and Rolwing-Moxley together advanced equal amounts. El Sombrero did not issue any notes in exchange for these advances, made no provision for and paid no interest, put up no security, gave no understanding as to repayment, and in fact never repaid any of the advances (Pet. App. B A5-A6; Pet. App. C A13).

In 1965, El Sombrero executed 30 leases for more than 7,000 acres of land on the east coast of Mexico. A few months later, petitioner's president and sole stockholder opened a bank account in El Sombrero's name, arranged for El Sombrero to borrow almost $500,000 from Cook & Company, and moved to Mexico and commenced the farming operations (Pet. App. B A6; Pet. App. C A14).

Successive hurricanes destroyed a large part of El Sombrero's crop. As a result, El Sombrero was forced to cease operations in 1968 because of financial difficulties. Cook & Company thereupon sued El Sombrero in the Mexican courts and obtained a $95,052.78 judgment against it. Because Raffety had guaranteed payment of El Sombrero's notes, it was first made a party to the suit and its private plane was seized. However, the plane subsequently was returned to it (Pet. App. B A6; Pet. App. C A14, and n. 1).

In its tax returns for 1966 and 1967, petitioner deducted its unrecovered advances to El Sombrero on the alternative grounds that they were a loss under Section 165(a) of the Internal Revenue Code of 1954, a loss from a bad debt under Section 166(a), or an ordinary and necessary business expense under Section 162(a). On audit, the Commissioner determined that petitioner's unrecovered advances to El Sombrero were only deductible as capital losses under Section 165(f).

The district court held that petitioner's unrecovered advances to El Sombrero were deductible as business expenses. Although the district court acknowledged that El Sombrero was an association taxable as a corporation, it held that El Sombrero should be disregarded because it was a "passive entity" which performed "no substantial business function" and served only to "allow the Missouri partners to farm in Mexico without being in violation of Mexican law" (Pet. App. B A8-A11).

The court of appeals reversed. It concluded that the evidence established that El Sombrero was a "viable, commercially active company operating on a million-dollar scale in Mexico which afforded its true owners complete protection from personal liability" and which did not act as the agent or nominee of petitioners, Joslyn or Rolwing-Moxley. The court of appeals therefore held that petitioner's $222,000 payment to El Sombrero, as a recognizable

separate entity, was a capital investment the loss on which was deductible only as a capital loss (Pet. App. C A15-A20).

The classification of El Sombrero as a separate corporate entity accords with *Moline Properties* v. *Commissioner*, 319 U.S. 436. There, the Court stated that, whatever the purpose for the formation of a corporation, "so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity" (*id.* at 439). Here, the undisputed evidence demonstrated that El Sombrero contracted for leases of land, maintained bank accounts, borrowed money, and was sued, all in its own name. There was no evidence that in its dealings with third parties, El Sombrero acted as agent for petitioner or its associates. See *National Carbide Corp.* v. *Commissioner*, 336 U.S. 422, 437. Under *Moline Properties*, El Sombrero's activities constituted the carrying on of business and justified treating it as a separate taxable entity.

Petitioner does not dispute the correctness of the foregoing authorities but argues (Pet. 8-9) that the understanding of the principals that El Sombrero was to be a partnership should control. However, the legal effect of the formation of El Sombrero was the creation of an association taxable as a corporation. See *Morrissey* v. *Commissioner*, 296 U.S. 344; Treasury Regulations, Section 301.7701-2(a). See also *Abbot Laboratories International Co.* v. *United States*, 160 F. Supp. 321 (N.D. Ill.), affirmed *per curiam*, 267 F.2d 940 (C.A. 7). Thus, petitioner's losses arose from an unsuccessful investment in the capital of another corporation, which must be treated as a capital loss.

Indeed, this Court long ago rejected an argument similar to petitioner's in *Helvering* v. *Coleman-Gilbert*, 296 U.S. 369, where the taxpayer argued that the parties intended to form a trust and not a corporation. In holding that the resulting entity was taxable as a corporation, the Court stated (*id.* at 374): "The parties are not at liberty to say that their purpose was other or narrower than that which they formally set forth in the instrument under which their activities were conducted."

For the reasons stated, it is respectfully submitted that the petition for a writ of certiorari should be denied.

ROBERT H. BORK,
Solicitor General.

JULY 1975.